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§ 2.02 The Basic Carried Interest

As indicated above, the heart of the private equity fund segment of the capital markets is incentive compensation for the Sponsor. The most important element of incentive compensation takes the form of a profits interest which is greater than the Sponsor's capital interest. This profits interest is commonly referred to as a "carried interest", a "promote" or "promoted interest" or an "override". In the case of Leveraged Buyout Funds and Venture Capital Funds, the private equity funds are ordinarily organized as limited partnerships (or other entities such as limited liability companies which are taxed as partnerships). In private equity funds of this kind, the Carried Interest is typically structured for tax purposes as an allocation of a portion of the partnership's profits. This preserves the underlying tax characteristics of the Fund's income and gain for the General Partner as well as the individual partners or members of the General Partner since the General Partner entity is also in most cases an entity treated as a partnership for tax purposes. For private equity funds with investment strategies such that significant portions of their income take the form of capital gains, preservation of the capital gains character of incentive compensation in the hands of individual sponsors is a critical structuring feature.

Many Hedge Funds generate much smaller portions of their income in the form of long-term capital gains, a feature which lessens the importance of structural devices that treat incentive compensation as a partnership allocation. Moreover, the fact that the Carried Interest in Hedge Funds is typically measured by unrealized as well as realized gains reduces further the significance of the partnership allocation approach. As a result, the Carried Interest in a Hedge Fund may take the form of a fee paid to the Manager based upon a formula set out in a management contract and treated as an expense by the Hedge Fund. However, in such cases it is generally vital to structure the Hedge Fund so as to avoid a material income tax payable at the Hedge Fund entity level.

[1]—Size of the Carried Interest

At the outset it is worth noting that almost any participant in the private equity fund arena would concede that a Carried Interest of at

least 20% is the current market standard for Venture Capital Funds, Leveraged Buyout and Merchant Banking Funds and Hedge Funds. The Mercer Report asserts that common use of the 20% Carried Interest "is attributable to the early years of the private equity industry where a 20% carried interest was considered to be a substantial incentive for the general partner's performance."¹ A Carried Interest in excess of 20% remains uncommon. Higher rates are most frequently charged in the Venture Capital area and, more recently, by Sponsors in all areas with exceptionally strong past performance records. In the case of a Fund of Funds, a lower Carried Interest (e.g. 5%) is more typical. In significant part, this is attributable to reluctance on the part of investors to pay a full 20% Carried Interest to the General Partner of the Fund of Funds when the underlying funds will also charge a Carried Interest. An additional factor is the common perception that there is less performance to reward in a Fund of Funds. The General Partner of a Fund of Funds has an important role in selecting the underlying funds. However, once the initial investment decisions have been made, there is little opportunity for the Fund of Funds to influence or contribute to the performance of the underlying funds.

These factors have been less compelling in one area. A Fund of Funds with an investment strategy focused on the secondary market for interests in private equity funds will often charge a higher Carried Interest, in some cases a full 20% Carried Interest. This may reflect the fact that the market for secondary interests, although growing, remains limited and, accordingly, the higher level of incentive compensation is considered reasonable for General Partners who have demonstrated the ability to access transactions as well as the ability to effectively price and execute purchases of these difficult to value investments.

A Fund of Funds that acquires secondary interests will typically focus on interests where a majority or more of the Capital Commitments have already been funded. Thus, the General Partner must not only assess the management of the prospective portfolio fund but must also establish an acceptable price for the selling investors' indirect interest in the underlying Portfolio Companies.

In the case of a Captive or Semi-Captive Fund, some discount from the conventional 20% Carried Interest in favor of the lead investor is typically part of the rationale for the creation of the Fund. However, as noted above, the discount will ordinarily be implemented by providing

¹ *Key Terms and Conditions for Private Equity Investing*, 14 (William M. Mercer Inc. 1996).

the lead investor with an equity stake in the General Partner.²

From an analytical point of view, it seems clear that the Carried Interest motivates the General Partner and the Principals to achieve the economic expectations of the investors, superior investment performance in the form of capital appreciation and high profits. The value of the Carried Interest increases in direct proportion to the achievement of these goals.

Although the Carried Interest can be said to serve the alignment of interest concept, it is worth noting that this is a validation of the structure of the compensation rather than the amount. The alignment of interests is achieved so long as the Carried Interest represents the exclusive or primary form of significant compensation. Depending on the size of the private equity fund and the other sources of income to the Sponsor and the Principals such as Management Fees and Transaction Fees, it seems clear that, from a purely analytical point of view only, alignment of interests can in some cases readily be served with lower rates of Carried Interest.

The foregoing suggests that, in the end, the size of the Carried Interest is largely a function of price and that the comparative lack of material variations in price (i.e. the size of the Carried Interest) is probably attributable to the relative lack of transparency in the markets for private equity funds. Otherwise, one would anticipate greater variation in the measure of the Carried Interest. It also seems probable from a more purely analytical point of view that a marketplace for private fund advisors characterized by substantially greater transparency would lead to a significantly greater correlation among such factors as fund size and actual performance and the size of the Carried Interest.

As discussed below, Preferred Returns and Hurdle Rates can be viewed as tools to promote a degree of correlation between performance and incentive compensation in the sense that investment performance must exceed the Preferred Return or Hurdle Rate before any Carried Interest will be paid.³ However, in most private equity funds that have a Preferred Return, only a single performance benchmark is used (e.g., a return of 8% per annum). When a fund achieves a rate of return large enough to allow for the General Partner Make-up, the Carried Interest percentage is applied to all incremental profits. It is also worth noting that private equity funds that use Carried Interest percentages that exceed 20% are usually successful in doing so based on historical performance of different investment portfolios. Historical

² See § 1.07 *supra*.

³ See generally, § 2.03 *infra*.

performance is clearly relevant to a pricing term such as the size of the Carried Interest percentage. Nonetheless, it seems anomalous from an analytical point of view that higher Carried Interest percentages are rarely conditioned upon matching the historical investment returns used to justify them. In other words, the Sponsors and the Principal may use a 50% internal rate of return in a prior fund to justify a 25% Carried Interest in a new fund. However, the 25% Carried Interest will typically apply across the board to the new fund (subject only to any Preferred Return) without regard to whether investment returns for the new fund come close to those of the prior fund.

As a technical matter, greater correlation between current investment performance and the size of the Carried Interest percentage could readily be achieved by use of multiple levels of Preferred Returns. A few private equity funds have adopted this approach. For example, the Carried Interest percentage can be structured to increase from 20% to 30% as investment returns increase from 30% to 50% per annum. Although the logic of approaches of this kind appears compelling, they remain the exception rather than the rule. Almost half a decade late after the collapse of the Internet and telecommunications bubble, it does not appear that investor discontent has led to refinements of this kind.

[2]—Fund Income Subject to the Carried Interest

Agreement as to the size of the Carried Interest represents an important step in specifying the economic bargain of the parties to a private equity fund relationship. It is however just one of a number of factors which can influence economic outcomes in a material way. The Carried Interest broadly understood consists of a percentage of profits or gains. However, since private ordering is the defining characteristic of the private equity fund relationship, it is necessary to be specific, both analytically and contractually, in terms of defining how the Carried Interest percentage will be applied.

[a]—Accounting

A threshold question when the parties begin to focus on how to apply the Carried Interest percentage involves accounting. A private equity fund which qualifies as a partnership for Federal income tax purposes is generally required to maintain capital accounts in accordance with the accounting method used by the tax partnership for

Federal income tax purposes.⁴ In general terms, each partner of a tax partnership has its own capital account. The capital accounts of all of the partners taken together correspond generally to the consolidated stockholders' equity account (i.e. paid in capital, capital surplus and retained earnings) characteristic of a typical corporate balance sheet which is more familiar to most investors.

Ordinarily, the capital account of a partner is credited with the amount of any Capital Contributions by the partner and increased by the amount of net income of the partnership allocated to that partner. A partner's capital account is decreased to reflect the amount of distributions to that partner as well as by the amount of net loss of the partnership allocated to that partner.

It is worth noting that all of the net income and net loss needs to be allocated. This is essential for tax purposes since the partnership is not itself a taxpayer. Additionally, from a non-tax point of view the net worth of a partnership is necessarily the sum of the interests of the partners. There is no concept of unallocated earnings or surplus and thus no parallel to the undifferentiated stockholders equity and retained earnings accounts characteristic of a corporate balance sheet.

As noted above, the United States Internal Revenue Code requires the maintenance of capital accounts reflecting the accounting used for Federal income tax purposes. This requirement is grounded in the rules which govern when allocations to the partners of items of income, loss, deduction and credit will be respected for tax purposes. These rules are not otherwise a legal impediment to the flexibility afforded to partners in structuring their economic relationship. In other words, structuring contractual capital accounts which vary, in some cases significantly, from tax capital accounts is neither illegal nor inappropriate. Variations simply need to be understood and evaluated in terms of their potential tax consequences.

In many cases, contractual capital accounts will be largely consistent with tax capital accounts. However, some differences are almost invariably necessary. For example, from a contractual point of view the partners may desire or need to take account of cash income which is not recognized as income for Federal tax purposes. Similarly, partners may decide to take account of certain cash expenses for purposes of their economic interrelationships despite an inability to deduct or amortize those expenses for tax purposes. Perhaps most dramatically, partners may decide that their economic interests will be determined by including unrealized gains and losses, none of which would ordi-

⁴ For discussion in greater detail, see Chapter 5 *infra*.

narily have significance from a pure tax point of view.

The key points to be derived from the potential significance of varying accounting methodologies are two. First is the importance of specific contractual language governing the determination of income and loss. Second is the need to understand clearly the interplay of contractual accounting and tax accounting.

[b]—Income From Portfolio Investments

In the case of Venture Capital Funds and Leveraged Buyout Funds, it is invariably the case that the income base to which the Carried Interest percentage will be applied includes capital gains. Since the investment strategies of these private equity funds focus on capital appreciation, the inclusion of capital gains is inherent in the basic economic bargain.

In some cases, investors will advance the theory that, given an investment strategy focused upon medium and long-term capital appreciation, it is appropriate to limit the Carried Interest to capital gains and to exclude dividend and interest income. This argument is increasingly rare and even more rarely successful. In part, this development can be attributed to a fundamental inconsistency with another theory advanced by investors regarding other economic issues — namely, that profits should be determined broadly on a cash-in-cash-out basis which includes such expense items such as Management Fees and Organizational Expenses. At least as important, an attempt to exclude interest and dividend income can be viewed as dysfunctional from an alignment of interest point of view. Exclusion tends to make the General Partner and the Principals indifferent to the receipt of interest and dividends. Even though most investments by Venture Capital and Leveraged Buyout Funds are made without any expectation of current income in the form of dividends or interest, it does not appear that elimination of the incentive to receive this kind of income usefully serves the investors. As is often noted in negotiations over issues of this kind, 80% of something is bound to be better than 100% of nothing.

In the case of Hedge Funds, net income and net loss are ordinarily defined so as to include unrealized gains and losses, as well as realized gains and losses, interest and dividends. In many instances, this is accomplished by references to the difference between the net asset value of a Hedge Fund's assets at the beginning and at the end of the applicable accounting period. Net asset value is ordinarily defined as the excess of the market value of the Hedge Fund's assets over its liabilities.

[c]—Other Income

In the case of Hedge Funds, the typical approach to defining net income and net loss by reference to changes in net asset value necessarily incorporates income from any source. In the case of other types of private investment funds, a distinction is sometimes drawn between income attributable to Portfolio Investments (i.e. interest, dividends and capital gains) and other income. For example, a Venture Capital Fund or a Leveraged Buyout Fund may invest the proceeds of Capital Contributions on a short term basis pending consummation of the purchase of a Portfolio Investment. In addition, some private equity funds are able to earn commitment fees or break-up fees in circumstances where a commitment to make a Portfolio Investment is made but the actual investment is never consummated.

Some investors take the position that income of this kind should be excluded for purposes of calculating the Carried Interest. In the case of break-up and commitment fees, this argument is another one which seems dysfunctional from an alignment of interest point of view. This approach eliminates the General Partner's incentive to earn fees of this kind and there is generally no way to assess objectively whether such fees might have been available.

The investor's argument to exclude income from short-term investments pending purchase of a Portfolio Investment or the distribution of sales proceeds to the partners is more compelling. It is hard to argue that performance based compensation is appropriate when the act in question involves selecting an interest bearing bank account or a money market fund. Moreover, the short-term investment of funds is ordinarily a routine action so that the General Partner's stake in its share of the private equity fund's cash provides sufficient incentive to ensure that money will not sit idle. However, it should be noted that a modified approach to this question is reasonable in the case of Funds which have a Preferred Return or Hurdle Rate. In these circumstances, it may be appropriate to allocate and distribute short term investment income in proportion to Capital Contributions but to include these distributions for purposes of determining whether the Preferred Return or Hurdle Rate has been satisfied. This approach avoids direct payment of Carried Interest in respect of short term investment income but does not penalize the General Partner by continuing to accrue a Preferred Return in addition to the income generated by the short investments.

[d]—Calculations of Profits

Since private ordering and negotiated contractual arrangements are

defining characteristics of private equity funds, it is unsurprising that the definition of profits for purposes of calculating the Carried Interest is subject to numerous different approaches. In part, the breadth of variation is related to different investment strategies.

The most significant difference in the approach to defining profits attributable in this regard can be seen in a contrast between Hedge Funds on the one hand and Leveraged Buyout Funds and Venture Capital Funds on the other. Hedge Funds are generally characterized by an investment strategy which focuses on financial assets for which market quotations are available. Accordingly, from an analytical point of view there is merit to defining the profits of a Hedge Fund by reference to unrealized gains and losses as well as realized gains and losses. To the extent that on any given date the value of a particular financial asset is established in a liquid market such as the market for United States treasury securities, the difference between unrealized and realized gains and losses can be viewed as merely a question of timing. Thus, the use of a "net asset value" approach to defining the profitability of a Hedge Fund can be said to serve the alignment of interest concept since it represents the most accurate measure of performance at any particular point in time.

It is worth noting, however, that the theoretical soundness of the net asset value approach may in some cases be overridden by market forces. The breadth and liquidity of the markets for different types of financial assets varies significantly. For example, the "markets" for certain mortgage backed securities or financial derivatives may be more limited and thus less consistently reliable. In addition, from time to time in the past, turmoil and uncertainty in the capital markets have for varying lengths of time rendered segments of these markets extremely illiquid. This occurred most recently in September and October of 1998, when economic distress in Asia followed by devaluation of the currency in Russia led to a period when many classes of financial assets were impossible to value using the conventional techniques of obtaining multiple bids to purchase.

In contrast to Hedge Funds, Venture Capital Funds and Leveraged Buyout Funds pursue investment strategies involving the purchase of securities for which, at least initially, there are no market prices. The valuation of a privately-held business corporation absent an actual sale is inherently uncertain. Thus, these Funds focus primarily on realized gains from the sale of Portfolio Securities and take account of unrealized gains only if there is a distribution in kind after a public market has developed to validate pricing determinations. In addition, Venture Capital and Leveraged Buyout Funds generally take no account of

unrealized losses except in cases where a Portfolio Investment has become worthless or an external event such as a bankruptcy of a Portfolio Company results in a permanent impairment to the value of the Portfolio Investment.

The issue of unrealized loss has, however, become increasingly sensitive in the case of Leveraged Buyout Funds and Venture Capital Funds because investors have balked at paying Management Fees based upon a percentage of the cost of Portfolio Investments in circumstances where the investment has been written down for financial reporting purposes.

[i]—Aggregation

Aggregation is a term used to refer to the netting of gains and losses from different investments for purposes of determining profits and the Carried Interest. Aggregation was never an issue with Hedge Funds since netting is inherent in the calculation of net asset value.

In the case of other Funds, aggregation has become commonplace and is now rarely controversial. Historically, this was not the case. In the 1970's and the early part of the 1980's, Venture Capital Funds and Leveraged Buyout Funds did not use aggregation. Rather, the Carried Interest was calculated on a transaction by transaction basis.

As noted before, a transaction by transaction approach to calculating the Carried Interest is fundamentally dysfunctional from an alignment of interest perspective. It tends to create a bias in favor of higher risk and potentially higher return investments. The only cost to a General Partner if losses are realized on a particular investment are reputational and the General Partner's share of the capital applied to the particular investment. This same dynamic could also be expected to lead General Partners to devote less effort to salvaging troubled companies. At this point, however, the analytical arguments for aggregation are largely irrelevant since a transaction by transaction approach to calculating the Carried Interest has virtually been eliminated.

[ii]—Management Fees

In the case of Venture Capital Funds and Leveraged Buyout Funds, the question of whether Management Fees are included as an expense for purposes of calculating the profits subject to the Carried Interest remains controversial. Strong pressure has been exerted by institutional investors, especially in the case of Leveraged Buyout Funds, to include Management Fees as an expense. This approach is certainly

understandable from the institution's point of view since the internal portfolio managers will almost certainly be evaluated on a cash out cash in basis.

This is not an issue with any significant implications for the alignment of interest concept. As long as the most significant portion of the General Partner's compensation takes the form of the Carried Interest, interests remain fundamentally aligned. Negotiations concerning whether Management Fees are treated as an expense in the calculation of the Carried Interest should be recognized as a negotiation over price. Thus, this issue tends to be resolved based on the relative bargaining power of the parties.

There appears to be an increasing trend to include Management Fees as an expense for purposes of profit calculations. In a pattern similar to the spread of aggregation in the 1980's, this trend largely resulted from institutional pressure in the Leveraged Buyout Fund arena. As was the case with the spread of aggregation, institutional investors often prevail on a negotiated point in the case of start-up funds where the institutions' bargaining power is greatest. Although far from a universal, at this point in time the markets seem clearly to be moving in this direction albeit more slowly in the case of Venture Capital Funds.

[iii]—Organizational Expenses

As is the case with Management Fees, the question of whether Organizational Expenses are included as an expense when calculating the profits subject to the Carried Interest remains controversial in the Venture Capital and Leveraged Buyout Fund area but less so. The arguments and the market trends with respect to this question are largely similar. However, the fact that Organizational Expenses represent one-time start-up costs unrelated to the investment process have led some General Partners to resist treating Organizational Expenses in the same manner as Management Fees. Institutional investors which focus on this point tend to find this distinction unpersuasive. However, since this also is essentially a pricing issue, the outcome in negotiations often turns on the stature and track record of the General Partner and the Principals rather than analytical merits.

§ 2.03 Preferred Returns

Preferred Returns were largely non-existent before the middle of the 1980's. They have now become commonplace for Leveraged Buy-

out Funds and Funds of Funds which charge a Carried Interest. Preferred Returns are less common in the case of Venture Capital Funds and Hedge Funds. However, larger Venture Capital Funds which need to attract institutional investors increasingly accept some form of Preferred Return.

If one accepts the proposition that investors approach private equity funds with an expectation of higher returns and somewhat higher risk, a Preferred Return serves the alignment of interest concept by linking the Carried Interest to superior performance. Investors sometimes express this point in negotiations by asking why they should give up 20% of the profits attributable to their capital if a higher return could have been obtained in a money market fund or other low risk investment.

The appeal of this argument from an investor's point of view is obvious, but overbroad generalizations can be misleading. From a purely analytical point of view it is not obvious that no Carried Interest should be payable unless investment returns exceed a specified level. Compensation structures do not always impose requirements of this kind. For example, corporations frequently grant stock options to executives and establish the exercise price based on the underlying stock price on the date the option is granted. The interests of the executive are considered aligned with those of the shareholders in the sense that the stock must appreciate in order for the option to have value. However, the exercise price of corporate stock options does not typically increase over time which means that the corporate executive participates in the appreciation of the stock on a first dollar basis and his or her incentive compensation is not conditioned upon superior performance. The magnitude of the incentive compensation (i.e. the increase in share prices) does of course increase in proportion to superior performance as measured in the public equity markets. This analogy may be more compelling in case of smaller Funds where the fixed compensation of the Principals derived from Management Fees may be less than that of executives with comparable levels of experience in more conventional financial institutions.

[1]—General Partner Make-Ups

A distinction exists between Pure Preferred Returns and Preferred Returns or Hurdle Rates. In the former case, the Carried Interest percentage is applied only to profits in excess of the specified return. This has the effect of reducing the Carried Interest as a percentage of total profits.

In contrast, the use of a General Partner Make-Up provision can

eliminate all substantive economic effect of a Preferred Return if total investment returns are high enough. An example may be helpful.

For ease of reference, assume the following Carried Interest formula:

- (1) 100% of profits are allocated to investors until they have received a 10% return.
- (2) 100% of profits are allocated to the General Partner until the General Partner has received 20% of cumulative profits.
- (3) all remaining profits are allocated 80% to the investors and 20% to the General Partner.

In the foregoing example, if total profits equal or exceed a 12.5% return, the General Partner receives 20% of total profits and the interim allocations of the Preferred Return are ultimately without economic substance. Obviously, a different result follows at lower return levels.

Clearly, an important factor in evaluating a Carried Interest formula which has a Preferred Return is the character of the General Partner Make-Up. This is an area where there remains substantial variation.

While the General Partner Make-Up allocation is often 100%, it is not uncommon to see interim allocations of 80% to the General Partner and 20% to the investors or even 50% to the General Partner and 50% to the investors. From the investor's point of view, the important point is the level of overall investment returns necessary for the General Partner to receive the full Carried Interest percentage of cumulative profits. This level is, in effect, the definition of superior performance for purposes of the Carried Interest formula.

[2]—Formulating Hurdle Rates and Preferred Returns

A wide variety of techniques are used to formulate Preferred Returns and Hurdle Rates. One approach is to apply a variable interest rate such as the yield on one-year United States treasury securities (with or without a spread) or the London Interbank Offered Rate. This approach is sometimes attractive to financial institutions which are accustomed to analyzing investment opportunities in terms of a spread over the cost of funds of the financial institution.

A second approach used in formulating Preferred Returns involves the use of a market index. An index may reflect a broad range of market performance as in the case of the Standard & Poors 500. Alternatively, there are indices which may relate more directly to the investment strategy of a particular private equity fund or to private

equity funds generally. Examples of these kinds of indices include the Salomon High-Yield Market Index and the property index prepared by the National Council of Real Estate Investment Fiduciaries. Private companies such as Cambridge Associates also prepare performance benchmarks based on information obtained from a broad range of private equity funds.

To the extent that the purpose of a Hurdle Rate or a Preferred Return is to establish a benchmark for superior performance, there is an analytical bias in favor of using an index which relates closely to the investment strategy of a particular Fund. Nonetheless, the most common approach in formulating a Preferred Return continues to be a fixed target rate. Fixed rate Preferred Returns commonly range from 5% to 12%. Currently, a fixed rate of 8% appears to be a frequent starting point for Sponsors.

The formulation of the Preferred Return is one of the areas which distinguishes the Captive or Semi-Captive Fund segment. The lead investors participating in the organization of a Captive or Semi-Captive Fund are much more likely to have the sophistication and bargaining leverage to formulate a Preferred Return which reflects a relevant market index.

A final point to note in connection with the formulation of Hurdle Rates and Preferred Returns is the question of compounding. In other words, in cases where the Preferred Return is defined by reference to an interest rate, the issue is whether the calculation of the Preferred Return reflects compounding on an annual, semi-annual, quarterly or other basis. Although there does not appear to be a clear standard regarding this issue, annual compounding is increasingly common in the case of Leveraged Buyout and Merchant Banking Funds.

[3]—Calculating Hurdle Rates and Preferred Returns

An important consideration for purposes of evaluating a Preferred Return relates to the way in which the Preferred Return is applied during the life of a typical private equity fund. Again, a simple example can provide a useful illustration.

For ease of calculation, assume that a Fund has a 10% Preferred Return with a 100% General Partner Make-Up and that on the first day of its operation the Fund makes ten investments, each costing \$10 million. On the first anniversary of commencing operations, one investment is sold for \$20 million. The General Partner must distribute the Preferred Return to investors before it receives any Carried Interest. However, is the Preferred Return calculated by reference to all Capital Contributions (i.e. \$100 million) or by reference to the Capital

Contributions applied to the investment which has been sold (i.e. \$10 million)?

Clearly, the answer to this question can have a material effect on the timing of distributions. In the former case, the General Partner receives no current distribution of Carried Interest. In the latter case, a Carried Interest distribution of \$2 million is made.

In circumstances where Management Fees and Organizational Expenses are included as expenses for purposes of determining the Fund's "profits", a similar question arises. Again, for ease of calculation, assume that the Fund has paid \$1.5 million in Management Fees and \$500 thousand in Organizational Expenses. If all of these expenses are applied to reduce the \$10 million of investment gains realized on the first sale, then even if the Preferred Return is calculated only by reference to realized investments (i.e. \$10 million of recovered capital), the current Carried Interest distribution is reduced from \$2 million to \$1.6 million.

A common alternative approach is to reduce current profits by the portion of total Management Fees and Organization Expenses corresponding to the portion of total Capital Contributions attributable to the realized investment. In the foregoing example, the original cost of the realized investment represents 10% of total Capital Contributions. Under this approach, 10% of the \$2 million in total expenses needs to be recovered on a preferential basis. This reduces profits to \$9.8 million and reduces the current Carried Interest distribution from \$2 million to \$1.96 million.

If the Carried Interest formula provides that Management Fees and Organizational Expenses (or an allocable share of these expenses) must be recovered before Carried Interest distributions are made, an additional question arises. Does the Preferred Return accrue with respect to amounts used to pay these expenses?

From the investor's point of view it is clearly preferable to have the Preferred Return calculated on a total cash basis. Nonetheless, Sponsors have generally (although not universally) been successful in insisting that the Preferred Return is calculated only by reference to capital applied to the actual cost of realized investments and investment related expenses. In the case of Leveraged Buyout Funds where Preferred Returns are most common, investors are increasingly successful in terms of including a recovery of Management Fees and (to a lesser extent) Organizational Expenses as part of the Preferred Return formula. On the other hand, Sponsors who succeed in having the Preferred Return calculated by reference to realized investments are usually successful in limiting the recovery of expenses to the allocable

portion described above.

Despite continuing pressure from institutional investors on this point, a substantial portion of Sponsors continue to resist requests that the Preferred Return be applied to amounts used to pay Management Fees and Organizational Expenses. In this connection, Sponsors often argue that they cannot be expected to earn a return on monies expended for start-up costs and routine operating expenses. This argument is clearly true in a literal sense but ignores the fact that the true "cost" of an investment may be more than the nominal purchase price. It is worth noting that this is purely a pricing issue and does not have any obvious relationship to the alignment of interests.

When a Fund has a Carried Interest formula which calculates a Preferred Return by reference to realized investments, the investors should pay careful attention to the issue of write-downs. Even though Venture Capital and Leveraged Buyout Funds do not ordinarily take account of unrealized gains or losses, there are circumstances in which it may be appropriate to make an exception for unrealized losses. For example, if a Portfolio Company files for bankruptcy, equity securities of the bankrupt Portfolio Company may become essentially worthless even though there has not been a sale or other disposition to validate the permanent loss of value.

Sponsors generally do not object to treating a security becoming worthless or a similar material and permanent loss of value in the same manner as a realization. However, Sponsors do resist contractual provisions which take account of fluctuations in the value of Portfolio Companies when such fluctuations are not clearly permanent.

A Carried Interest formula which calculates a Preferred Return by reference to realized investments should also be assessed in terms of a particular Fund's investment strategy. For example, this approach would ordinarily not make sense if applied without some modification to a private equity fund that invests in high yield debt and preferred stock. An investment of \$10 million in a high yield instrument may generate annual dividends of \$1 million or more. However, since the income is not triggered by a disposition of the underlying investment, a focus on realized investments only will not require any distribution in respect of the Preferred Return. In cases of this kind, it is common to provide that dividends and interest must be used to satisfy the Preferred Return on the capital used to acquire the investment generating the income notwithstanding the absence of a realization event.

§ 2.04 Timing Issues and the Carried Interest

[1]—General Timing Issues

Questions as to how the Carried Interest and any Preferred Return or Hurdle Rate are calculated go to the heart of the economic bargain embedded in the typical private equity fund. Issues of timing can be equally important, particularly in the area of Venture Capital and Leveraged Buyout or Merchant Banking Funds.

The importance of timing issues on the Carried Interest formula in Venture Capital and Leveraged Buyout Funds relates to the cycle of investment and realization ordinarily characteristic of these Funds. A Venture Capital or Leveraged Buyout Fund can be expected to make investments in a number of separate Portfolio Companies over a three to five year investment period. While investment holding periods can vary dramatically, holding periods of three to seven years are common.

Aggregation, the practice of netting gains and losses from different investments, has become all but universal with private equity funds. However, given the length of time during which a typical Venture Capital or Leveraged Buyout Fund makes and sells investments, the question of at what point or points of time the profitability of the Fund is determined assumes considerable importance.

In one sense, an investor who makes a Capital Commitment to a Fund does not know that its investment is profitable until the investor has recovered its entire Capital Commitment. Moreover, the precise amount of profits is not known with certainty until the Fund is liquidated and wound up.

As a theoretical matter, the uncertainty associated with interim determinations of the profitability of a Fund could be addressed by restricting any Carried Interest distributions until the investors have recovered their entire Capital Commitments. However, this approach is rarely followed. Rather, almost all private equity funds operate with an implicit assumption that unrealized investments will generate proceeds at least equal to their carrying value.

It seems likely that three factors are largely responsible for the approach followed by most Venture Capital and Leveraged Buyout Funds. As noted before, historically the Carried Interest was ordinarily calculated on a transaction by transaction basis. Even though the markets have moved to aggregation, there remains inertial resistance to netting based on an assumption that the carrying cost of remaining investments will not be realized. In addition, a requirement to return all Capital Commitments on a priority basis would tend to defer Car-

ried Interest distributions until late in the life cycle of a typical Fund. Sponsors vehemently resist this result.

The third factor which is often used to support earlier distributions of Carried Interest involves tax considerations. As noted before, one of the significant attractions for the Principal of a Venture Capital or Leveraged Buyout Fund relates to the opportunity to receive the Carried Interest in the form of a profits interest in an entity taxed as a partnership. To the extent that the income realized by a Fund is long term capital gain, the flow through character of the income comprising the Carried Interest distributions results in significantly lower tax rates.

Tax issues will be more fully discussed later on.¹ For the moment, it is sufficient to note that if the Carried Interest is to be subject to taxation at favorable capital gains rates, capital gains realized by the Fund need to be allocated to the General Partner in a manner which will be respected by the taxing authorities.

Allocations of income and loss are generally respected for tax purposes if they have substantial economic effect. In simple terms, the substantial economic effect of partnership allocations is determined by reference to capital accounts.

Each partner of a partnership has a capital account. The balance of any partner's capital account is increased by capital contributions and allocations of net income and decreased by distributions and by allocations of net loss. As a simple rule of thumb, an allocation of capital gain will be respected for tax purposes if, assuming the partnership were liquidated at book value immediately after the allocation in question, distributions to partners would be made in accordance with the adjusted balances in the capital accounts.

A simple example may be helpful. Assume the case of a Fund with no Preferred Return which makes two investments each costing \$10 million. One investment is sold for \$20 million, representing \$10 million of recovered capital and \$10 million of capital gain. If the Fund's distribution provisions provide that 20% of profits over the life of the Fund must be distributed as Carried Interest to the General Partner, then 20% of the \$10 million of capital gain must be allocated to the General Partner in order for the Fund's allocation of income to be respected. This allocation will increase the General Partner's capital account by \$2 million.

It is important to note that tax considerations do not directly govern the distribution of the \$20 million of sales proceeds in the foregoing

¹ Tax issues of this kind are discussed in Chapter 6 *infra*.

example. The entire \$20 million can be distributed to the investors. The investors start out with capital account balances of \$20 million, reflecting their Capital Contributions. The capital accounts of the investors are temporarily increased by \$8 million, reflecting 80% of the \$10 million gain, and decreased by \$20 million, reflecting the distribution of all of the sales proceeds. The remaining capital account balances are \$8 million for the investors and \$2 million for the General Partner. If the Fund is liquidated at book value, its remaining investment will generate \$10 million which can be distributed in accordance with capital account balances.

Although the approach reflected in the foregoing example works well in theoretical terms, it has less appealing aspects from the point of view of the General Partner and the Principals. The key difficulty is that taxes are required to be paid in the year in which the income is allocated, without regard to whether distributions are made. Thus, in the above example, the Principals would either have to borrow money or to use the after-tax portion of other income to pay their shares of tax on the \$2 million allocation. The corollary of this is the distribution of the \$2 million, if and when made, would not be a taxable event.

Given the economic benefit of qualifying for taxation at capital gains rates, it is not surprising that most Venture Capital and Leveraged Buyout Funds allocate taxable income in a manner similar to that reflected in the example. In addition, it appears that a substantial majority of Venture Capital and Leveraged Buyout Funds provide for distributions of Carried Interest following a distribution of capital (and Preferred Return, if any) relating only to those investments which have been sold or written off. Private equity funds which do generally defer Carried Interest distributions until the investors have recovered all of their capital still ordinarily allocate the taxable income in the manner described above and almost always provide for a partial distribution of cash to the General Partner in an amount designed to cover taxes on the Carried interest allocation. Although even a tax distribution creates some risk to the overall economic bargain between the General Partner and the investors, acceptance of this minimal distribution is all but universal.

[2]—Clawbacks

When a Fund has contractual provisions governing allocations and distributions which provide for distributions of Carried Interest before 100% of the investors' Capital Commitments (together with any Preferred Return) has been recovered, it is necessary to consider the consequences when initial investment gains are followed by sales of

investments for cost or at a loss. This sequence of events can result in distributions of Carried Interest early in the life of a Fund even though the Carried Interest formula would produce a smaller or no Carried Interest if applied at the end of the life of the Fund.

Many investors view the gain followed by loss sequence as a natural as well as common result, especially in the case of Venture Capital and Leveraged Buyout Funds. This viewpoint stems from the observation that successful Portfolio Companies are often quickly sold while troubled Portfolio Companies require more time to fix.

A Clawback is a contractual provision which adjusts for distortions of the intended economic bargain attributable to the timing of gains and losses. Typically, these provisions are effective at the time of the liquidation and winding up of a Fund and, depending on the Carried Interest formula and the cumulative performance of the Fund, obligate the General Partner to return all or a portion of a prior distributions of Carried Interest. Amounts returned by the General Partner are then distributed to the investors.

From an alignment of interest perspective, the arguments in favor of some form of Clawback are compelling. If early Carried Interest distributions are allowed, a Clawback may be essential to achieve aggregation. Moreover, it seems reasonable to assert that the results of a specific economic bargain should not vary significantly based on the timing of dispositions, particularly since one party to the bargain, the General Partner, controls decisions as to timing.

When a Clawback is to be provided, the precise content of the contractual provision can be enormously significant. One series of questions involves the scope of the Clawback. In other words, is the General Partner obligated to return all distributions of Carried Interest or only some portion.

Tax considerations are often a factor in the negotiations of a Clawback. For example, some portion of a distribution of Carried Interest will have been used to pay taxes on the related allocations of taxable income. Thus, Sponsors often assert that they can't return what they don't have and attempt on that basis to limit a Clawback to the after-tax portion of prior distributions of Carried Interest.

Discussions regarding reductions to a Clawback obligation to give effect to taxes often become complicated. The Carried Interest is ordinarily allocated and distributed in the first instance to the General Partner. Typically, the General Partner is an entity also taxed as a partnership with more than one partner, each of whom receives some portion of the Carried Interest and pays the related tax. Accordingly, determining the actual taxes paid on any particular dollar of Carried

Interest can be time consuming, expensive and ultimately problematic.

For the foregoing reasons, Sponsors often take the position that it is appropriate to reduce a Clawback obligation by reference to a hypothetical tax rate rather than the actual taxes paid by the Principals and others. Often this is done by reference to the highest combined federal, state and local marginal tax rate in the place where the General Partner's office is located. If a Fund is institutionally sponsored, reference to corporate rates may be appropriate. Otherwise, individual rates are ordinarily used. If a hypothetical tax rate is used, the investor should take care that the contractual language implementing the Clawback gives appropriate effect to the character of the income comprising the Carried Interest distributions as well as the deductibility of state and local taxes for Federal income tax purposes.

Of the Funds which have Clawbacks, a substantial majority appear to reduce the Clawback amount by reference to taxes. In addition, most investors accept the argument that use of a hypothetical tax rate represents a reasonable and cost effective method to determine the reduction.

In recent years, some institutional investors have argued that if a Clawback is reduced by reference to taxes paid, it should also be increased by reference to any tax benefits associated with the return of monies to the Fund and the related distributions to the investors. Superficially, this argument is appealing as it seems only to require equal treatment.

In practical terms, many investors devote more attention to the question of tax benefits than is warranted. The most important goal served by the Clawback is the alignment of interests. Furtherance of this goal does not appear to be undermined in meaningful way by a failure to take full account of tax benefits.

Although the potential tax consequences associated with a Clawback can be complicated, the likely result is that the individuals who directly or indirectly fund the Clawback will recognize a short-term capital loss. It seems improbable that a windfall tax benefit in the form of a short term capital loss would have any significant effect on the motivation or decision making process of the individuals responsible for managing a private equity fund. Moreover, determining the value, if any, of the tax benefit can be time consuming, expensive and potentially uncertain. A short term capital loss may in fact produce no actual benefit depending upon the amount and character of the income of the taxpayers. Thus, precise calculation of the benefit requires examination of the tax returns of those who receive the loss allocation..

A much more important consideration from the investors' point of

view is the formulation of the Clawback triggering event. In many private equity funds, a Clawback provision is triggered if the General Partner receives on a cumulative basis more than 20% of profits (however defined). In the case of a Fund with a Preferred Return this simple approach may not be appropriate. It is clearly desirable from the investor's point of view to refine the provision so that it also operates if the investor has not received the full Preferred Return over the life of the Fund.

[3]—Security for the Clawback

If a Fund has a Clawback, it is important from the investor's point of view to focus on the sources of payment if the Clawback obligation is ultimately triggered. In the first instance, the Clawback obligation represents a contractual undertaking by the General Partner under the Fund's partnership agreement. However, it is rarely the case that this undertaking is sufficient.

In most cases, the General Partner will be a limited liability entity established for the sole purpose of serving as the General Partner. Typically, the General Partner will not have any material assets other than its interest in the Fund.

Carried Interest and other distributions received by the General Partner would ordinarily be immediately redistributed to the Principals and other persons with equity interests in the General Partner. Thus, if a Clawback obligation is triggered at the end of the life of the underlying Fund, the General Partner cannot be relied upon to have the resources to satisfy the obligation.

One approach to this issue is to have Principals and other persons who are the ultimate recipients of Carried Interest distributions guaranty the Clawback obligation. Investors sometimes assert that guarantees of this kind should be joint and several, with the result that any ultimate recipient of a portion of the Carried Interest distributions is personally liable for 100% of the Clawback obligation. The Mercer Report takes this position and observes that the joint and several guaranty "provides flexibility and facilitates collections if necessary."²

Notwithstanding the view noted above, in most cases individual guarantees of a Clawback obligation are limited to the portion of the Carried Interest distributions received by the particular individual. On balance, this is generally the more reasonable approach, since the lim-

² *Key Terms and Conditions for Private Equity Investing*, 21 (William M. Mercer Inc. 1996).

ited guarantee is probably sufficient to achieve the alignment of interest goal. A different result may be appropriate, however, if the General Partner is substantially owned by a financial institution. An example of a proportionate guaranty of a clawback obligation is set out as Exhibit K.

The potential difficulties associated with collecting amounts owed under a Clawback provision lead some investors to require that some portion of Carried Interest distributions be reserved or held in escrow in order to satisfy the Clawback. At one extreme, the reserve could be structured to include the entire after-tax portion of Carried Interest distributions. This approach is strongly resisted by Sponsors since it may defer any meaningful Carried Interest distributions until late in the life of the Fund. Reserve accounts representing up to one half of the after tax Carried Interest are more common.

The use of escrow or reserve accounts cannot yet be described as a market standard. However, as is the case with many other issues, pressure from institutional investors has increasingly led to the adoption of escrow and reserve accounts with Leveraged Buyout and Merchant Banking Funds.

Some Sponsors have attempted to use a reserve account as a basis to limit the size of the Clawback obligation. A typical approach is to provide that 50% of the after-tax portion of Carried Interest will be held in reserve. However, in these cases, the amount subject to the Clawback cannot exceed the balance in the reserve.

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